Foreign Tax Issues for US Citizens Abroad

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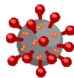
Summary

Whether here or overseas, US taxpayers face a myriad of issues and must contend with countless special forms. This course will help the practitioner assist American clients who live, travel and work abroad. Topics will include foreign earned income and foreign housing exclusions, the foreign tax credit, information for military personnel, inter-agency cooperation, and tax avoidance schemes.



Includes updates with regards to COVID-19 relief legislation

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The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. Introduction

In contrast to most other nations, the United States (US) operates under a worldwide tax system which means that US citizens and resident aliens owe taxes to the US, even if their foreign source income is also subject to taxation abroad. To mitigate tax liabilities resulting from double taxation, US taxpayers may take advantage of an exclusion for foreign earned income and/or a credit for duplicative taxes paid to a foreign government.

In some instances, it may be beneficial to claim a credit rather than an exclusion if the tax rate in the foreign country is higher than that to which the taxpayer is subject in the US or if the taxpayer is ineligible to claim the exclusion. However, the exclusion has the obvious benefit of removing income from the tax equation as well as reducing AGI for purposes of computing Schedule A and other limitations.[1]

By availing themselves of the exclusion or the credit (or both), taxpayers may be able to significantly reduce or even eliminate their US tax liabilities. However, US persons abroad remain subject to applicable tax regulations in the host country and may be liable for foreign taxes. Nevertheless, the focus of this manual is on US tax law only.

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II. US Citizens Living Abroad[2]

US citizens and resident aliens living abroad have the same filing requirements as those living in the US. All amounts of income and expenses must be reported in US dollars on the tax return using the prevailing exchange rate at the time the income was received or the expense paid.[3]

Extensions[4]

If the taxpayer is living outside of the US on the due date of his return (April 15th), he will receive an automatic two-month extension to file (until June 15th) and must attach a statement of explanation to his return when filing. A taxpayer will receive an automatic six-month extension (until October 15th) if he files **Form 4868 Application for Automatic Extension of Time to File U.S. Individual Income Tax Return**. Taxpayers living abroad may choose to file **Form 4868** as late as June 15th but will still only receive an extension until October 15th.

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[1] A taxpayer's choice to use the credit or the exclusion is binding in the year first made as well as in all future years unless revoked by attaching a statement to **Form 1040**. Once revoked, the election cannot again be changed for 5 years without IRS consent.

[2] See *IRS Publication 54—Tax Guide for US Citizens and Resident Aliens Abroad* for additional information.

[3] Historical rates are available at www.fiscal.treasury.gov (last accessed May 1, 2020) or any online currency converter.

[4] Taxpayers taken hostage receive automatic extensions until the 15th day of the third month after their eventual release.

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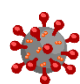
In the alternative, **Form 2350 Application for Extension of Time to File U.S. Income Tax Return** may be filed if a taxpayer expects to file **Form 2555 Foreign Earned Income** but needs time to meet either the Bona Fide Residence or the Physical Presence tests to qualify for the Foreign Earned Income and/or the Foreign Housing exclusions or deduction.



Due to the global pandemic, all taxpayers who have a filing or payment deadline that falls between April 1st and July 15th, 2020 are entitled to an automatic extension until July 15th, 2020.[5] The extended deadline applies to **Form 1040** and any FATCA forms required to be attached to the individual income tax return. The COVID-extension, however, does not apply to FBAR filings which are *automatically* extended to October 15th if not filed timely on April 15th.

<u>Withholdings</u>

US employers must withhold US income tax from wages paid to US citizens living abroad unless the employer is required by law to withhold foreign income tax. If a Social Security or Totalization Agreement is in effect between the US and a foreign country, the employee will only pay Social Security tax to the country in which he is working.[6] However, if he normally works abroad but is sent to the US to work temporarily, he will pay Social Security taxes only to the foreign host country.[7]

If the taxpayer is eligible for the Foreign Earned Income or Foreign Housing exclusions and expects these exclusions to eliminate most if not all of his US tax liability, he may use **Form 673 Statement for Claiming Exemption From Withholding on Foreign Earned Income Eligible for the Exclusion (Provided by Section 911)** to exempt the employer from US withholding requirements.

III. Military Personnel[8]

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Includes all uniformed members serving in the Army, Navy, Air Force, and Coast Guard.

Pay received by military and civilian employees of the US government is generally not considered to be foreign earned income and, therefore, ineligible for the Foreign Earned Income Exclusion. Such pay includes designated combat pay while on active duty in a presidentially declared combat zone,[9] as well as most allowances (e.g. living, death, family, moving and travel) and in-kind benefits (e.g. medical and dental care, childcare assistance and commissary discounts).

Other items of income are includable as taxable income: Active and reserve duty pay; special pay (including hostile fire and special duty), as well as re-enlistment bonuses, leave and other payments. While taxable, military personnel cannot claim the Foreign Earned Income Exclusion because such

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[5] IRS Notice 2020-23.

[6] Reg. §301.6114-1(c)(vi).

[7] The US currently has Social Security agreements in effect with 30 countries - Australia (2002), Austria (1991), Belgium (1984), Brazil (2018), Canada (1984), Chile (2001), Czech Republic (2009), Denmark (2008), Finland (1992), France (1988), Germany (1979), Greece (1994), Hungary (2016), Iceland (2019), Ireland (1993), Italy (1978), Japan (2005), Luxembourg (1993), the Netherlands (1990), Norway (1984), Poland (2009), Portugal (1989), Slovak Republic (2014), Slovenia (2019), South Korea (2001), Spain (1988), Sweden (1987), Switzerland (1980), the United Kingdom (1985), Uruguay (2018). [as per Social Security Administration, https://www.ssa.gov/international/agreements_overview.html, last accessed April 29, 2020].

[8] See *IRS Publication 3—Armed Forces Tax Guide.*

[9] Eligible for Combat Pay Exclusion is available to enlisted members, warrant officers and commissioned warrant officers, as well as commissioned officers (up to a specified limit) [IRC §112].

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individuals generally do not have a foreign tax home.[10] Under a special exception,[11] contractors or employees of contractors providing support to US Armed Forces in designated combat zones are eligible to claim the Foreign Earned Income Exclusion even though they continue to have an abode in the US. This exception was intended to put contractors (ineligible for the Combat Pay Exclusion) on equal footing with military personnel serving in a combat zone.

Extensions

Military personnel are entitled to an automatic two-month filing extension if serving outside of the US. Those on duty in a combat zone receive an additional grace period of 180 days.[12]

IV. Available Exclusions and Deductions

To qualify for foreign earned income exclusions and deductions, the taxpayer must:

1. have foreign earned income; AND
2. be a US citizen or resident alien who either:
   (a) resides in a foreign country for at least one full tax year from January 1st through December 31st (Bona Fide Residence Test [BFR]) OR
   (b) is physically present in the foreign country for at least 330 days during any consecutive 12-month period (Physical Presence Test [PPT]); AND
3. have a tax home in a foreign country (with no abode in the US).

Special Rules

The BFR is *not* automatically satisfied once a taxpayer has resided in the foreign country for a full tax year. In fact, if a taxpayer has made a statement to foreign authorities that he is not a resident of the host country and he has been granted an exemption from local income taxation, he will be *unable* to satisfy the BFR.

If the taxpayer satisfies the PPT in a period that spans two tax years, he may claim a pro-rated portion of the exemption in each year.

Craig moved abroad on August 2, 2018 and will satisfy the 330-day requisite time limit by June 29, 2019 if he does not return to the US in the interim. Once he satisfies the test and files his 2018 return, he may claim an exclusion equal to $42,699 [= 150/365 days X $103,900].

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[10] Abode – as distinguished from tax home – is not an individual's main place of business or employment but rather where he maintains family, economic and personal ties. Most military personnel maintain an abode in the US and, therefore, do not have a foreign tax home required to claim the Foreign Earned Income Exclusion.

[11] Bipartisan Budget Act of 2018.

[12] If a member of the US Armed Forces dies while on active duty in a combat zone, his entire income tax liability is forgiven for the year of death and one preceding year.

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Definitions

Only "full days" spent in the foreign country count; thus, travel days and dates of arrival and departure are not included in the count.[13] **NOTE:** The taxpayer is not required to be employed when counting days but may be retired or on vacation as long, as he does not return to the US for more than 35 days in any 12-month period.

A "tax home" may be (a) the taxpayer's main place of business or employment, or (b) the place where he is permanently or indefinitely engaged to work, and (c) may depend on whether the work is temporary (less than one year) or indefinite. **NOTE:** An itinerant's tax home is wherever he works.

A "foreign country" is defined as any territory under the sovereignty of a government other than that of the United States.[14] US possessions such as Guam, American Samoa, US Virgin Islands or Puerto Rico are not considered "foreign".[15] However, territorial waters, airspace, seabed and subsoil adjacent to territorial waters over which a foreign country has exclusive rights in accordance with international law with regards to the exploration and exploitation of natural resources are considered "foreign". **NOTE:** International airspace or water used to pass from one country to another is not considered a part of any foreign country.

To determine whether compensation may be eligible for the Foreign Earned Income Exclusion, taxpayers must look to where the services are performed; not from where they are paid or the location of the taxpayer at the time payment is received. For example, wages earned by a flight attendant in international airspace of, in or over the US do not qualify as foreign earnings.[16] Nor are a merchant marine's earnings in international – not territorial – waters eligible for Foreign Earned Income Exclusion.[17]

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Amanda is a US citizen who lives and works abroad. She has lived in Germany for 14 months—from September 1, 2017 through October 31, 2018. However, she is unable to meet the Bona Fide Residence Test since she has not been in Germany for a full *calendar* year. Instead, she can pass the Physical Presence Test.

Joe flies helicopters in Saudi Arabia and works a 28-day on/28-day off schedule. He returns to his family residence in the US during his off periods.[18] He is considered to have an abode in the US and does not satisfy the tax home test in the foreign country. He cannot claim the exclusions.

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[13] **TIP:** Since the proper day count is critical, a taxpayer may obtain a 5-year travel history with all US entry and departure dates from the US Customs and Border Protection I-94 website at https://i94.cbp.dhs.gov/I94/#/home [last accessed May 1, 2020]. If the information is not available online, an individual may submit a Freedom of Information Act (FOIA) request at https://foiaonline.gov/foiaonline/action/public/request [last accessed May 2, 2020].

[14] Applying this definition, the 7th Circuit Court of Appeals upheld IRS denial of a taxpayer's claim for the Foreign Earned Income Exclusion: Arnett, a US citizen, attempted to exclude wage income of $48,894 earned while working at McMurdo Station in Ross Island, Antarctica. However, Antarctica has been deemed to be a *sovereign-less* region based on the Antarctic Treaty of 1961 that provided that the continent was to be used for peaceful and scientific purposes and that all questions of sovereignty would be put into abeyance. [*Arnett v. Comm*., 2007-1 USTC 50,162; 7th circ. 06-1934.]

[15] Treas. Reg. 1.911-2(h).

[16] *Rogers v Comm,* TC Memo 2013-77.

[17] *Wilson et ux v Comm*, TC Summary Opinion 2016-19.

[18] *Bellwood, et ux. v Comm*, TC Memo 2019-135.

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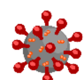
Bob is a marketing executive with a US company that transferred him to London for a minimum of 18 months. Before he left, Bob distributed business cards showing his new business and home addresses in London. He kept ownership of his US house but rented it to another family after moving his family, furniture and pets to London. He and his wife obtained British driving licenses, opened local bank accounts and joined a neighborhood civic association. Bob's abode is in London—he satisfies the tax home test in the foreign country.

Time Limits

The time limits for the Bona Fide Residence or Physical Presence tests may be waived if the taxpayer is forced to leave the foreign country due to war or civil unrest as determined annually by Internal Revenue Bulletin.[19]



With the worldwide spread of COVID-19, the IRS has announced[20] that eligibility for the Foreign Earned Income Exclusion will not be impacted as a result of days spent away from a foreign country due to travel delays if the taxpayer had reasonably expected to satisfy the time limits during 2019 or 2020. To qualify for this relief, an individual must have already established residency or been physically present in the foreign country prior to the applicable dates. But for the pandemic, these individuals must have expected to have been in-country for at least 330 days. They may use any 12-month period to satisfy the requirement. **TIP:** A taxpayer who has already filed a 2019 return without claiming the Foreign Earned Income Exclusion but now qualifies based on the relief provided in the Revenue Procedure, may file an amended return.

Mallory was physically present in Poland from January 1st through March 1st, 2020 and reasonably expected to remain in-country for the entire calendar year. She had hoped to make a quick visit to the US on March 2nd but due to COVID-related travel disruptions, she was unable to return to Poland until August 10th. She will nevertheless satisfy the PPT even though she was not abroad for all 330 days during 2020.

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TIP: If a taxpayer is unable to satisfy the Bona Fide Residence or Physical Presence tests by the due date of his return but expects to meet the requisite time limits to claim the Foreign Earned Income Exclusion, he may submit **Form 2350** to: Department of the Treasury – Internal Revenue Service Austin, TX 73301-0045.

Generally, an extension will be granted until 30 days after the date on which the taxpayer satisfies the time limit under the tests.[21] This form may be filed only once for each move overseas; once the taxpayer meets either time test and remains abroad continuously, he must file **Form 4868** to request

[19] Each year, the IRS announces the country and date of applicable waiver of residency requirements for the prior tax year. For TY'10: Haiti (on or after January 13, 2010) and Cote d'Ivoire (December 19). For TY'11: Egypt (February 1), Libya (February 21), Syria (April 25), and Yemen (May 25). For TY'12: Central African Republic (December 28), Sudan (September 15), and Tunisia (September 15). For TY'13: Egypt (July 3), Lebanon, (September 5), Pakistan (August 9), Yemen (August 6), and South Sudan (December 17). For TY'14: Libya (July 26) and Yemen (September 24). For TY'15: Burundi (May 14). For TY'16: South Sudan (July 10), and Turkey (October 29). For TY'17: None. For TY'18: Democratic Republic of the Congo (December 14), Cuba (January 4), Iraq (September 28), and Nicaragua (July 6). For TY'19: Democratic Republic of the Congo (January 13), Venezuela (January 24), Haiti (February 14), Iraq (May 14), and Sudan (April 11). For TY'20: To be announced in early 2021.

[20] Rev. Proc. 2020-27: Individuals who left China on or after December 1, 2019 or any other foreign country on or after February 1, 2020 but before July 15, 2020, will be treated as physically present in or a bona fide resident of that foreign country during that period.

[21] An extension may be granted up to 90 days after the end of the year following the year the taxpayer moved to the foreign country, if moving expenses are required to be allocated. **NOTE:** An extension of time to file (but not pay) an income tax return also extends the time to file **Form 709 Gift and Generation-skipping Transfer Tax Return**.

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an extension for any future year. As with all extensions, a **Form 2350** extension merely extends the time for filing but not payment – a taxpayer, who believes he will owe tax, should submit a payment with his extension application on or before April 15th.

Once the Physical Presence Test has been satisfied, the taxpayer may check to see if he can amend a prior-year return on which he did not claim the income exclusion because he had not yet been in-country for the requisite 330 days.

NOTE: If the taxpayer resides in a foreign country in violation of US law,[22] neither test can be met and thus, the taxpayer is not eligible for the exclusions.

<u>Qualifying Income</u>

Foreign Earned Income must be paid for personal services performed and includes wages, salaries, commissions, bonuses, professional fees, tips and self-employment income. It does not include:

- The value of meals and lodging.
- Pension or annuity payments.
- Social Security or Medicare benefits.
- US government salaries paid to civilian or military personnel.[23]
- Income for services performed in international waters or in specific combat zones.
- Investment or passive income.
- Gambling winnings.
- Alimony.

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The source of the income is determined by the location of where the work is performed, not by the payee's location when payment is received nor by the nationality or locale of the payer.

Lastly, the exclusion may only be claimed by filing a tax return. Thus, **Form 1040** *must* be prepared whether or not that taxpayer expects to have a tax liability.

A. Foreign Earned Income Exclusion

> The maximum exclusion for 2020 is the lesser of $107,600/year or the amount of the foreign earned income less any foreign housing exclusion claimed. If both spouses work in a foreign country and meet the qualifications for the exclusion, up to $215,200 of foreign earned income can be excluded in 2020. The excludable limit is adjusted annually for cost-of-living.[24]

NOTE: Although excluded, foreign earned income may still be subject to Social Security taxes under some circumstances.

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[22] Cuba is still the only country to which travel restrictions have been continuously applied. However, IRS Notice 2006-84 provides that civilian individuals who are performing services at the US Naval Base in Guantanamo Bay Cuba are eligible for Foreign Earned Income and/or the Foreign Housing exclusions, provided that they otherwise meet all of the usual eligibility criteria.

[23] A US citizen working in Germany for the US Department of State under a personal services agreement was deemed to be a US government employee for federal income tax purposes and therefore ineligible to claim the Foreign Earned Income Exclusion. [*O'Kagu v Comm*, 151 TC 6, Sept. 20, 2018.] A US civilian who was deployed to Afghanistan and served in units led by a NATO commander did not receive foreign earnings since he was an employee of the US Department of Defense. Had he been hired by NATO as an independent contractor prior to his deployment, he would have been eligible for the exclusion. [*Striker v Comm*, TC Memo 2015-248.]

[24] The maximum exclusion amounts in prior years were: $76,000 (2000), $78,000 (2001), $80,000 (2002 – 2005), $82,400 (2006), $85,700 (2007), $87,600 (2008), $91,400 (2009), $91,500 (2010), $92,900 (2011), $95,100 (2012), $97,600 (2013), $99,200 (2014), $100,800 (2015), $101,300 (2016), $102,100 (2017), $103,900 (2018), $105,900 (2019) and $107,600 (2020).

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The exclusion is not automatic; rather, the election to claim the exclusion must be affirmatively made on a timely filed return or a late-filed return within one year after the original due date.[25] The exclusion remains in effect in the year elected and all future years unless affirmatively revoked by attaching a statement to the original or amended return in the year of revocation.[26] Once revoked, the taxpayer must wait 5 years or apply for IRS approval to use the exclusion again.[27] **NOTE:** Not filing **Form 2555** in years without foreign earned income does *not* constitute a revocation.

If the exclusion is claimed, the taxpayer may not also claim the Foreign Tax Credit for taxes paid on the excluded income (and may not claim the Earned Income Credit). The taxpayer may choose to use whichever vehicle offers the greater benefit.

For example, it may be preferable for US citizens living in The United Kingdom (UK) to elect the Foreign Tax Credit rather than the exclusion since UK tax rates are generally higher than those in the US; the resulting excess tax credits can be carried forward and used to reduce US tax liabilities for up to 10 years.

On the other hand, it may be preferable to use the exclusion for income earned in the United Arab Emirates (UAE) since qualified expats living and working in the kingdom are not subject to foreign taxation. Because the credit can only be claimed for taxes paid, US taxpayers should instead use the exclusion to reduce or eliminate the amount of income subject to US taxation.

Similarly, low tax rates in Hong Kong (HK) will likely make the credit less attractive than the exclusion. And because housing costs are exceptionally high in HK, US taxpayers who keep careful records of rent, utility costs and residential parking may also claim a deduction for those costs.

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B. Foreign Housing Exclusion

Amounts received for employer-provided housing (less a government-calculated base amount) are eligible for the exclusion.

[25] Treas. Reg. §1.911-7(a)(2).

[26] Treas. Reg. §1.911-7(b)(1).

[27] Rev. Proc. 2019-1

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The base amount (minimum) is calculated as follows:

- 16% of the amount of the Foreign Earned Income Exclusion for the calendar year in which the tax year begins (computed on a daily basis): In 2020, $107,600 × 16% = $17,216 divided by 365 days = $47.17/day

Multiplied by

- The number of days of the tax year within the applicable period of foreign residence (bona fide residence test) or presence (physical presence test) for that tax year

The maximum allowable Housing Exclusion is limited to 30% of the Income Exclusion:

- In 2020, $107,600 X 30% = $32,280 divided by 365 days = $88.44/day

Thus, only housing costs in excess of $47.17/day and less than $88.44/day are excludable – resulting in a total exclusion not to exceed $15,064 in 2020.

NOTE: Certain high-cost locales[28] are eligible for additional exclusion amounts.

Unless self-employed, all earnings are considered employer-provided, making the entire housing amount eligible for exclusion. To clarify, housing costs incurred by employed individuals are eligible for exclusion whether paid by the employer or by the employee, since it is presumed that an employee will use employer-provided funds (i.e., wages) to pay for these expenses. Do not be dissuaded from claiming the exclusion due to the bureaucracy's poor choice of wording: "Employer-provided housing" includes all of the employee's housing.

Housing expenses include rent, repairs, utilities, real and personal property insurance, occupancy taxes, furniture rental, and residential parking. **NOTE:** Deductible mortgage interest and property taxes, the cost of purchasing a property, the cost of domestic labor, leasehold and homeowner's improvements, and depreciation may not be included when calculating the Housing Exclusion.

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Tom was a bona fide resident of and had his tax home in Ghana from August 17, 2020 through the end of the year (= 136 days), while his wife Jane began her residency one month later on September 15th (= 107 days). Tom paid $10,000 for housing expenses; $7,500 of this amount was incurred from September 15th through the end of the year. Jane paid $3,000 for housing expenses.

Although Tom and Jane will file jointly, they can choose to let either Tom or Jane claim the housing exclusion in hopes of maximizing the allowable tax benefit:

- If Tom claims the housing exclusion, the couple's combined exclusion would be $6,585 (= $13,000 less the government-calculated base amount of $47.17/day X 136 days, or $6,415).
- If Jane instead claims the housing exclusion, their allowable exclusion would be $5,453 (= $10,500 expenses less the government-calculated base amount of $47.17/day X 107 days, or $5,047).

[28] Listed in the Instructions for **Form 2555**.

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On **Form 2555 Foreign Earned income**, the housing exclusion must be elected before the foreign earned income exclusion, as the IRS explains on its website:[29]

> *The foreign earned income exclusion is limited to the actual foreign earned income minus the foreign housing exclusion. Therefore, to exclude a foreign housing amount, the qualifying individual must first figure the foreign housing exclusion before determining the amount for the foreign earned income exclusion.*

This is frequently (but incorrectly) interpreted to mean that the housing amount must be deducted from total foreign earned income to arrive at the excludable amount for income exclusion purposes, which would imply that the combined total exclusion could not exceed the annual threshold amount. However, while foreign housing expenses may not exceed total foreign earned income for the taxable year, a taxpayer may nevertheless elect to claim the Foreign Housing Exclusion in addition to the Foreign Earned Income Exclusion, resulting in a combined exclusion that exceeds the annual threshold.[30]

In 2020, Joe's foreign earned income of $150,000 exceeded the annual limitation. Joe was eligible to claim the Foreign Earned Income Exclusion (up to $107,600) as well as the Foreign Housing Exclusion (up to $15,064). Joe's total 2020 exclusions equaled [$122,664 = $107,600 plus $15,064].

NOTE: Although amounts excluded under the income and housing exclusion are not taxed, they are nevertheless added back when computing regular and alternative minimum tax liabilities on all remaining income; thereby bumping taxable income into higher marginal tax brackets.

Taxpayer has $80,000 of foreign earned income eligible for the exclusion plus $20,000 of other non-excluded income which will be taxed at the marginal rate applicable to $100,000 (not $20,000).

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C. Foreign Housing Deduction

This deduction is *available only to the self-employed* and is limited to foreign earned income less any foreign earned income and/or housing exclusions claimed. Disallowed deductions in excess of the limitation may be carried over for one year only.

The deduction is calculated in the same manner as the housing exclusion but claimed on the front page of the taxpayer's **Form 1040** as an adjustment to gross income.[31] Thus, the deduction offers the self-employed taxpayer the possibility that he may actually exclude more from his taxable income than might otherwise be allowed by the foreign income and housing exclusions alone.

[29] https://www.irs.gov/individuals/international-taxpayers/figuring-the-foreign-earned-income-exclusion [last accessed May 2, 2020].

[30] Take a look at Page 3 of **Form 2555**, where you will find that the Housing Exclusion is calculated first on Line 36; the Income Exclusion is calculated next on Line 42; and the total allowable exclusion is calculated on Line 43 by combining Lines 36 and 42.

[31] Enter amount from **Form 2555**, Part IX, Line 50 on **Form 1040**, Schedule 1, Line 8 with the notation "Form 2555". Add this amount to all other adjustments claimed on Line 36 and subtract from gross income to arrive at Adjusted Gross Income (AGI).

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In 2020, Felipe's total foreign earned income was $130,000, of which half was from self-employment and half from services as an employee. Therefore, half of his total housing amount of $12,000 is considered to have been provided by his employer, allowing Felipe to claim $6,000 as a housing exclusion. The remainder is eligible for the housing deduction. However, because Felipe has exceeded the limitation ($107,600 in 2020) he must carry the $6,000 deduction forward to potentially claim in 2021.

D. Forms to File

- **Form 2555 Foreign Earned Income** must be attached to the tax return.
- **Form 2555-EZ** may be used if foreign earned income is less than the maximum exclusion amount, the taxpayer is not self-employed, and the taxpayer does not claim the housing exclusion or deduction.

E. Do the Exclusions Work?

The foreign income and housing exclusions have been available to US taxpayers living and working abroad since 1926; ostensibly, to achieve parity and make it more affordable for employers abroad to hire US citizens rather than local residents. IRS statistics for the most recently available tax year 2016, confirm that 481,000 taxpayers claimed the Foreign Earned Income Exclusion, roughly 0.4% of all individual returns filed. About 14% of these taxpayers also claimed the housing exclusion and deduction. More than half of the filers reported working for foreign employers primarily in Asia (33%) as well as the United Kingdom (17%), other European nations (21%), Canada (14%) and Mexico (5%). By claiming the allowable exclusions, 69% of US taxpayers filing from overseas were exempt from US taxation [and many were also not subject to taxation in the countries of their foreign residence].[32]

The GAO was asked to evaluate the efficacy of modifying or eliminating the available exclusions and found that "in terms of good tax policy, there is room for debate regarding how potential revisions to the current tax expenditure may affect choices about where to work and who to hire. It may have positive and negative effects on both the efficient allocation of labor resources, but the magnitude of these effects is unknown, making it unclear whether the tax expenditure provides any net economic benefits."[33] Nevertheless, the GAO suggested that "targeted tax relief" for extreme cost of living areas may be justified.

V. Foreign Tax Credit

To mitigate the effect of double taxation when US citizens or resident aliens – but not non-resident aliens – find themselves beholden to multiple jurisdictions, a taxpayer may elect to claim either a non-refundable credit (using **Form 1116 Foreign Tax Credit**) or a deduction (using **Schedule A Itemized Deductions**) for income taxes paid to foreign governments.[34] A taxpayer may elect the credit in one

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[32] *IRS Statistics of Income Bulletin*, Fall 2019 (available at https://www.irs.gov/statistics/soi-tax-stats-individual-foreign-earned-income-foreign-tax-credit, last accessed May 2, 2020].

[33] Godfrey, *Review Of Tax Exemption For American Expats Inconclusive*, Tax-News, Global Tax News [available at http://www.tax-news.com/news/Review_Of_Tax_Exemption_For_American_Expats_Inconclusive____64766.html, last accessed May 2, 2020].

[34] A one-time "windfall tax" imposed by the United Kingdom on utilities that were privatized was deemed eligible for a foreign tax credit because the tax was, in essence, a tax on income [*PPL Corp. v Comm*, US Supreme Court, No. 12-43].

Four tests must be satisfied for a foreign tax to qualify for the credit: (1) The tax must be imposed on the taxpayer, (2) the taxpayer must have paid (accrued) the tax, (3) the tax must be the legal and actual foreign tax liability, and (4) the tax must be an income tax or imposed in lieu of an income tax.

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year and a deduction in another but once elected, it applies to *all* foreign taxes paid or accrued during that particular tax year. **NOTE:** The election may be amended within 10 years from the due date of the return.

Certain taxpayers may claim the credit without filing **Form 1116** by entering the amount of the credit on **Form 1040**, Schedule 3, Line 48 if:

- All foreign source income is “passive category income” derived from interest and dividends which have been reported on Forms 1099 or Schedule K-1,
- The shares of stock generating dividend income have been held for at least 16 days,
- **Form 4563 Exclusion of Income for Bona Fide Residents of American Samoa** is not filed,
- Total foreign tax liability is under $300 ($600 if filing jointly), and
- All foreign taxes were legally owed, not eligible for a refund, and paid to a country that is recognized by the US and does not support terrorism.

No credit or deduction may be claimed for foreign income taxes paid on earnings excluded under the Foreign Earned Income or Foreign Housing exclusions; nor may a credit or deduction be claimed for foreign taxes:

- attributable to countries not recognized by the US government,
- excludable from US taxation based on international treaties,
- that would be refundable if the taxpayer filed a claim with the foreign government,
- of US persons controlling foreign corporations or partnerships,
- in connection with certain oil and gas transactions as well as mineral rights,
- on dividends from stock that has been held less than 16 days, and
- that are deductible only as Itemized Deductions (e.g. property[35] and value-added taxes).

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REMINDER: While certain taxes may be ineligible for the Foreign Tax Credit (Deduction), they may nevertheless be deductible elsewhere on the tax return if incurred in a trade or business or in the production of income.

While a credit generally yields a larger tax benefit, it may sometimes be better to claim a deduction, particularly if the taxpayer has incurred foreign taxes ineligible for the credit. On the other hand, a credit may be advantageous if the taxpayer’s itemized deductions are less than the Standard Deduction or he plans to carry his unused tax credit into other tax years.

Maximum Credit (Deduction)

The tax credit or deduction is limited to the lesser of the amount of US tax that would be attributable to the foreign income had it been taxed by the US, or the actual foreign tax paid.

A US citizen taxpayer was eligible to exclude his foreign earned income and did exclude $70,000 wages earned in India where he paid foreign income tax of $10,000. He also received dividends from India in the amount of $2,000 and paid a foreign income tax of $600 thereon. He can use the $600 tax payment for his foreign tax credit because the dividends relating to it were subject to US tax but cannot claim a credit against the income tax of $10,000 since it was paid on US-excluded income.

Creditable foreign taxes are limited to the lesser of statutory rate or the treaty rate (if applicable). A taxpayer subject to excess withholdings where the statutory rate exceeded the treaty rate, should not apply for a refund of withholdings.

[35] Property taxes are deductible whether or not the underlying property is US-sited.

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Jennifer received $2,000 of dividend income from Taiwan. As per applicable law, Jennifer was required to file a statement with the local withholding agent to notify him that she is eligible for a reduced treaty withholding rate of 15%. Because Jennifer did not file the statement, taxes were withheld at the statutory rate of 35%. The maximum foreign tax credit that Jennifer may claim is $300 (= $2,000 dividend X 15%). She will not receive a refund of the $400 excess tax withheld (= $700 actual withholdings - $300 treaty-based withholdings).

Tax Computation

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{US Income Tax before Credit}$$

If the other country has a higher tax rate than the US, there will be unused credits which may be carried back 1 year and forward 10 years; after which they expire if still unused.[36] If the other country has a lower tax rate than the US, the taxpayer will be required to pay the differential to the US.

Income tax rates in Germany may be as high as 60% but because the tax rate on the same income in the US is only 25%, that taxpayer may not claim a credit for the excess tax. However, he may carry the unused credit forward to future years.

Unused credits must be calculated separately for each category of income and then first carried back to the prior year. Any excess remaining may then be carried forward to the ensuing ten years in sequential order. A short tax year for which a return is filed is deemed to be a full tax year for credit carry-over purposes.[37]

Income Categories

Form 1116 classifies income into various categories or baskets: (a) §951A, (b) Foreign Branch, (c) Passive, (d) General, (e) §901(j) income from certain sanctioned countries, (f) income re-sourced by treaty, and (g) lump-sum distributions.[38]

a. Both §951A and Foreign Branch are new categories introduced in tax year 2018 with the enactment of Tax Cuts and Jobs Act (TCJA).[39] Commonly referred to as GILTI, §951A income is the amount of global intangible low-taxed income included in the gross income of certain US shareholders of foreign corporations.[40]

b. Foreign Branch Income consists of the business profits that are attributable to one or more qualified business units (QBUs) in one or more foreign countries, but does not include any

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[36] Carry-backs and forwards may, of course, only be used if taxable foreign income has been reported on the return to which the excess Foreign Tax Credit has been carried.

[37] IRC §904(c).

[38] As per IRS Instructions for **Form 1116**.

[39] Public Law 115-97 (enacted December 22, 2017).

[40] Final Treasury regulations regarding ILTI were issued June 14, 2019.

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passive category income.[41] The income of a foreign branch is subject to the 21% corporate tax rate and is not eligible for a lower rate. While foreign-source branch income can be offset by foreign tax credits, TCJA allows such income to be reduced only by taxes paid by the specific foreign branch and not other branches of the US consolidated group.

c. Passive Category Income generally includes dividends, interest, royalties, rents, pensions and annuities, net gain from the sale of non-income producing investment property or property that generates passive income, as well as net gain from certain commodities transactions.

d. General Category Income includes all income not otherwise categorized and may include wages, income earned from the active conduct of a trade or business, and gains from the sale of inventory or depreciable property used in a trade or business.

e. §901(j) income is derived from activities conducted in sanctioned countries. No credit is allowed for foreign taxes imposed by and paid to certain sanctioned countries. A foreign tax credit may be claimed for foreign taxes paid with respect to section 901(j) income if such tax is paid to a country other than a sanctioned country itself. For example, if a US citizen resident in a non-sanctioned country pays a residence-based income tax in that country on income derived from business activities in a sanctioned country, those foreign taxes would be eligible for the credit. If no taxes are paid to sanctioned countries, the taxpayer must only complete **Form 1116** for this category through Line 17.

f. If a sourcing rule in an applicable income tax treaty treats US-source income as foreign-source, and the taxpayer elects to apply the treaty,[42] the income will be treated as foreign-source.

g. Lump-sum pension distributions must be separately categorized.[43]

Since differing limitations apply to each category, separate **Forms 1116** must be filed for each category of income. **NOTE:** Separate **Forms 1116** must also be filed, depending on whether the foreign taxes were paid or accrued.

Foreign tax paid or accrued must be allocated to each category of income. If the tax is not specific to one category, the tax must be allocated in a pro-rata manner based on the net income of each category divided by total net foreign income. Gross income must be reduced by expenses directly attributable to each category. If the expenses are not definitively related to a particular category, they must be apportioned under the principles of the applicable foreign law first, then the principles of US law second.

[41] IRC §904(d)(2)(J).

[42] **Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)** must also be filed.

[43] **Form 4972, Tax on Lump-Sum Distributions** must be filed to elect annualized tax treatment.

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Paul earned wages of $100,000 as well as received interest income of $5,000 from Austria, on which he paid $6,400 income tax. He had deductions of $2,100 of foreign deductions that were not allocable to wither wages or interest income. Paul's net foreign income totaled $102,900.

Step 1: Expenses must be allocated to each category of income

- ($100,000 wages ÷ $105,000 total income) x $2,100 = $2,000 "wage" expenses
- ($5000 interest ÷ $105,000 total income) x $2,100 = $100 "interest" expenses

Step 2: Compute net category income

- $100,000 wages - $2,000 "wage" expenses = $98,000 net wage income (General)
- $5,000 - $100 "interest" expenses = $4,900 net interest income (Passive)

Step 3: Calculate the foreign tax attributable to each category of income

- ($98,000 net wages ÷ $102,900 total net income) x $6,400 = $6,095 "wage" taxes
- ($4,900 net interest ÷ $102,900 total net income) x $6,400 = $305 "interest" taxes

These allocated taxes, along with income and expenses, must be reported on separate **Forms 1116** with checkboxes for General Category and Passive Category Income marked, respectively.

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Functional Currency

All revenue and expense entries on a US return must be expressed in US dollars (USD). Similarly, foreign tax expenditures (if paid in a foreign currency), must be converted to on the date that the tax is withheld by an employer or submitted as an estimated payment or final payment with the filing of a foreign tax return. The taxpayer may use the historical exchange rates published by the US Treasury or any accepted currency converter, such as Oanda.com, xe.com or x-rates.com.[44]

NOTE: An accrual basis taxpayer must use the *average* exchange rate for the year to which the taxes relate if (a) the foreign taxes were paid on or after the first day of the tax year to which they relate, (b) the taxes are paid no later than two years after the close of that year, and (c) the foreign taxes are not paid in inflationary currency. Inflationary currency refers to the currency of a country in which there is cumulative inflation during the 36 calendar months immediately preceding the last day of the tax year of at least 30%.[45]

Paid or Accrued

Although the US employs a calendar year for individual income tax reporting purposes, many other countries do not. As a result, US taxpayers living abroad may have to apportion income and expenses reported to foreign tax authorities to accommodate the January to December reporting period mandated by the IRS.

[44] Links to these currency converters are provided by the IRS at https://www.irs.gov/individuals/international-taxpayers/foreign-currency-and-currency-exchange-rates (last accessed May 2, 2020).

[45] *2019 Instructions for Form 1116*, Department of the Treasury.

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Similarly, foreign taxes may be assessed on a fiscal year basis. Such taxes may be paid in advance or the liability may accrue and become payable on a filing date that falls within a new calendar year.[46]

A taxpayer may claim the credit in the tax year paid or accrued the foreign taxes, even if he is a cash-basis taxpayer, by checking the "accrued" box in Part II of **Form 1116**. But once the election to report accrued taxes has been made, the taxpayer must credit foreign taxes in the year they accrue on all future returns.

Separate **Forms 1116** must be submitted with the tax return to report those taxes which have accrued and those which have been paid. **NOTE:** With seven different baskets of income and the possibility that income in each category may be paid or accrued, a taxpayer with complex filing circumstances may have to submit as many as fourteen **Forms 1116**. And because each **Form 1116** provides only three columns for descriptive entries and numerical figures attributable to taxes assessed by different countries, some taxpayers may have to file many more **Forms 1116** to account for each category of income tax paid (accrued) to various localities! The aggregate of all foreign tax credits claimed should then be transferred to **Form 1040**, Schedule 3, Line 1.

<u>Allocations and Adjustments</u>

Foreign source income must be adjusted for foreign capital gains that are eligible for reduced rates, including long-term, collectible, un-recaptured §1250 and §1231 gains.

Interest expense must be apportioned between US and foreign source income, but charitable contributions are not apportioned against foreign source income.

Gross income (less cost of goods sold) should be entered on **Form 1116**, Line 1a and used to determine taxable income from sources outside of the US; whether revenues are passed through from a partnership or reported as self-employment earnings on Schedule C. Associated business deductions may be claimed on **Form 1116**, Line 2.

Foreign salary income must be sourced, with allocable amounts entered into separate columns for each source country, if total employee compensation from US and foreign sources exceeded $250,000. Compensation is sourced on a time basis; certain fringe benefits (such as housing and education) are sourced on a geographical basis.[47]

<u>Refund Claims</u>

Individual taxpayers have up to ten years to file a claim for refund of US income taxes paid if they find they paid (accrued) more creditable foreign taxes than previously claimed. The ten-year period begins the day after the regular due date for filing the return (without extensions) for the year in which the foreign taxes were paid or accrued. In 2020, amended returns may be filed to correct returns timely filed as early as 2010.[48]

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[46] If a foreign tax return is unavailable to substantiate a credit based on accrued taxes, the taxpayer must submit a certified statement and provide an accounting of foreign income along with a computation of the tax accrued thereon [Treas. Reg. §1.905-2(b)(2)].

[47] Instructions are available in *IRS Publication 514 Foreign Tax Credit for Individuals*.

[48] Based on IRS clarification in mid-2019, certain Social Security taxes paid to France may now retroactively be treated as income taxes for which a foreign tax credit is available since these taxes were not covered by the Agreement on Social Security between the two countries. Taxpayers should write "French CSG/CRDS Taxes" in red at the top of **Form 1040X** [additional information available at https://www.irs.gov/individuals/international-taxpayers/totalization-agreements, last accessed May 2, 2020].

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NOTE: While a taxpayer may also amend a return to switch from a previously claimed credit to a deduction, his refund claim may be barred by the customary 3-year statute of limitations.[49]

VI. Tax Issues Unique to Citizens Abroad

A. Foreign Retirement Accounts

In general, foreign pensions are not deemed to be "qualified" plans and instead are viewed as trusts by the IRS.[50] As a result, the tax treatment differs from that afforded to US employer-sponsored and individual retirement accounts. Typically, employee contributions are not tax-deductible and employer contributions are includible as taxable income. Additionally, income earned in the foreign retirement account is taxable to the participant on an annual basis. Finally, distributions are commonly subject to both foreign and US taxation. While some of this double taxation can be mitigated with the Foreign Tax Credit, plan participants should note that they will have been subject to US taxation at the time the income accrues and *again* when it is paid out, barring protections afforded by certain applicable tax treaties.

For example, US citizens living and working in the United Kingdom may invest in local pensions and retirement plans much in the same way they would if living in the US and contributing to a 401(k) or IRA and may even be able to deduct or exclude up to $55K ($61K if over age 50) of qualified contributions [in 2018]. And while employee and employer contributions to a Swiss Pillar II pension account may not be deducted from US taxable income, distributions may be withdrawn tax-free, much like US-based ROTH accounts. Unfortunately, international conformity is non-existent, and requires careful scrutiny of applicable tax treaties. Each treaty is unique, although many are based upon Article 18 of the Model Treaty[51] which allows a plan participant to deduct plan contributions and exclude employer contributions and defer accrued income.

NOTE: While the rare foreign pension plan may qualify as an exempt trust, most do not. Therefore, plan participants may be subject to reporting requirements on **Forms 3520**, **3520-A**, **FinCEN Form 114**, **Form 8938** [all discussed later in this manual], and potentially **Form 8621 Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund** (if the trust invests in foreign mutual funds), in addition to income tax reporting.

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<u>Passive Foreign Investment Companies (PFICs)</u>

Too complex and well beyond the scope of this text, the tax rules for PFICs nevertheless deserve brief mention, if only to provide preliminary insight and alert practitioners to potential

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[49] IRC §6511(d)(3). In CCA 201204008, the IRS made the special ten-year window for switching between credit and deduction a one-way street that only allows a change from deduction to credit. By contrast, a change from credit to deduction is not eligible for the ten-year limitation period; it can be made only within the standard three-year limitation period.

[50] The IRS defines a trust as an arrangement whose purpose "is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit" (Reg. §301.7701-4).

[51] The Model Treaty serves as the starting point for negotiations between countries. The Model is not legally binding, but its language is often incorporated verbatim into a negotiated treaty. [The Model is available at https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=6&ved=2ahUKEwjVtNOVnojiAhWSGXwKHRffAsUQFjAFegQIABAC&url=https%3A%2F%2Fwww.treasury.gov%2Fresource-center%2Ftax-policy%2Ftreaties%2FDocuments%2FTreaty-US%2520Model-2016.pdf&usg=AOvVaw07X8-LG3B9dKzeiwBHKqz3, last accessed May 3, 2020].

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pitfalls. A PFIC is an entity that holds mainly passive assets or receives mainly passive income from interest, dividends, capital gains, rents, etc.[52] PFICS typically include foreign mutual funds, money market accounts, pension funds, partnerships and other pooled investment vehicles, such as REITs.

The PFIC tax regime was created under the Tax Reform Act of 1986 with the intent of leveling the playing field between foreign and US-based mutual funds (which are required to pass-through all income to investors annually). Under PFIC rules, shareholders of affected foreign investment companies must report undistributed earnings; ultimately discouraging ownership by US investors. Under certain circumstances, taxpayers may elect to treat the PFIC as a Qualifying Election Fund (QEF) so that their foreign investment will be subject to annual taxation much like a US-based mutual fund, but even this election is complex and many PFICs are ineligible.

In the end, most taxpayers who hold one or more PFICs will have to file a *separate* **Form 8621** for *each* PFIC owned. The form(s) must be attached to the taxpayer's timely filed income tax return. Failure to file the form(s) may suspend the statute of limitations with respect to the taxpayer's entire return until the omission is corrected; potentially extending the statute for an unlimited period of time.

B. Social Security (SS) Benefits

Foreign SS benefits are generally taxed in the US as if they were foreign pensions or annuities and are often also taxed by the country making the payments. However, Totalization Agreements between the US and other nations can be used to mitigate the effects of double taxation. Under such agreements, SS benefits are typically taxed only by the country of residence rather than by the country in which the benefits accrued. For example, SS benefits paid to US residents by Germany and Canada are treated as if paid by the US and are, therefore, taxable only in the US subject to the same income-based inclusion rates of 50% and 85% as benefits paid by the Social Security Administration (SSA). **NOTE:** Only 26 countries currently have Totalization Agreements with the US.[53]

C. Deductions

1. Charitable Contributions

Generally, contributions to *foreign* charitable and religious organizations cannot be deducted. However, contributions to US charities which forward funds to foreign entities are allowable if the US organization controls the use of the funds. **NOTE**: Treaty provisions allow for deductions made to certain Canadian, Israeli, and Mexican organizations.

2. Moving Expenses

As per the TCJA, the deduction for moving expenses was suspended unless the taxpayer is a member of the US Armed Forces who moves pursuant to a military order and incident to a permanent change of station.

[52] IRC §1297.

[53] The list of countries is available at https://www.irs.gov/individuals/international-taxpayers/totalization-agreements (last accessed May 3, 2020).

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3. Travel Expenses

The rules are no different whether US citizens live in or outside of the US. To be deductible, travel expenses must be *directly related* to the taxpayer's trade or business and incurred while away from individual's tax home for longer than an ordinary day's work. For example, if living and working in Cairo, only travel expenses while traveling away from Cairo would be deductible. If working from two locations, the tax home is generally the locale where the taxpayer spends more time or generates more revenue.

For US taxpayers who live overseas on extended assignment, travel expenses are only deductible if they do not become "living" expenses. Therefore, if the individual's foreign assignment is *anticipated* to last more than one year, associated expenses are non-deductible even if the assignment is cut short and the taxpayer is sent back to the US prematurely. On the other hand, if the foreign posting was originally intended to be short-term but is later extended, travel expenses are deductible only up until that time that the taxpayer becomes aware of the expected duration's change.

4. Depreciation

Real property outside of the US used in a trade or business must be depreciated on a straight-line basis over a 40-year period; personal property held abroad must be depreciated over a 12-year period.[54]

The depreciable basis equals the cost of acquisition converted to US dollars using the currency exchange rate on the date of acquisition. For resident aliens, basis must be reduced by the amount of depreciation that would have been allowable (under US rules) during the period that the individual was an NRA, prior to changing residency status. **NOTE:** There is *no* automatic step-up in basis on the date of residency change, although certain transactions such as the sale of an asset to an offshore business entity may yield a basis step-up.

D. Sale of Foreign Real Estate

Capital gains resulting from the sale of real property held abroad must be computed based on the difference between the sales proceeds (converted to US dollars using the exchange rate in effect on the date of sale) and the acquisition cost (converted to US dollars using the exchange rate in effect on the date of purchase). Due to varying currency exchange rates, the taxpayer may be taxed on an unrealized gain if the exchange rate declined between the date of purchase and the date of sale.

If the property was encumbered by a mortgage on the date of sale, the taxpayer must *also* calculate the gain or loss resulting from the foreign exchange rate conversion when the loan is paid off. If the exchange rate increased in the period between loan inception and loan pay-off, it will cost the taxpayer more to repay the debt and, therefore, the taxpayer will realize a loss. If the mortgage was used to purchase a personal residence, this loss is non-deductible.[55] On the other hand, any gain attributable to a decrease in exchange rates will be reportable as ordinary income.

[54] IRC §168(g).

[55] IRC §165.

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On September 19, 2019 Henri sold a small villa on the French Riviera for €5 million. He had originally purchased the property on February 4, 2011 for €2.75 million with €1 million cash and an interest-only loan for the remainder. The sale must be reported in two parts as follows:

	Date	Euros (€)	Exch Rate ($/€)	USD ($)
Sales Proceeds	9/19/2019	5,000,000	1.1056	5,528,045
Purchase Price	2/4/2011	2,750,000	1.3581	(3,734,719)
Gain on Sale		2,250,000		1,793,326
Loan at Origination	2/4/2011	1,750,000	1.3581	2,376,639
Loan at Payoff	9/19/2019	1,750,000	1.1056	(1,934,800)
Gain from Exchange Rates				441,839

Due to currency fluctuations between the time of purchase and sale, it will cost Henri fewer US dollars to repay his foreign mortgage than he had originally anticipated. As a result, Henri will be required to report the gain on sale of the property ($1,793,326), as well as the ordinary income attributable to the currency exchange rate ($441,839). **NOTE:** Had interest rates gone against Henri during his ownership tenure, it would have cost him most US dollars to repay his loan. The resulting loss could not be used as an offset against the realized gain from the property sale since these are deemed to be two separate transactions. In fact, because the mortgage was a personal loan, the loss would be non-deductible in any case.[56]

If the foreign property had been Henri's primary residence, he could have excluded up to $250,000 (single) or $500,000 (married) of the realized gain if he has owned and lived in the home for at least two of the last five years.[57] Any gain that could not have been excluded under this provision would have been subject to US tax, as well as possibly foreign tax. Henri could then claim the Foreign Tax Credit for income taxes paid to France.

E. **Expatriation Tax** (a.k.a. Exit Tax)

US citizens who have renounced their citizenship and long-term US residents who have ended their residency may be subject to this tax for up to 10 years after the date of expatriation if the principal purpose for their actions was tax avoidance.

Citizenship is deemed relinquished if nationality is renounced before a US consular officer, a signed statement has been submitted to the State Department, the State Department issues a Certificate of Loss of Nationality, or a US court cancels a naturalized citizen's status.[58]

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[56] IRC §165(c).

[57] IRC §121.

[58] IRC §877A.

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The IRS will presume that avoidance was the primary purpose if:

- the taxpayer's average annual net income for the previous five years was in excess of $171,000 [in 2020],[59] or
- the taxpayer's net worth is in excess of $2 million, or
- the taxpayer is unable to certify that he has complied with US tax laws for the preceding five years

US citizens who relinquish their citizenship before age 18½ and were not residents for more than ten previous years are exempt from the Expatriation Tax; as are dual citizens if they became citizens of the US and another country at birth AND have no substantial contact with the US.[60]

The tax is assessed on all US-source income and gains without the benefit of any otherwise applicable tax treaty rates.[61] All global assets are treated as sold on the day prior to expatriation at fair market value; resulting gains are taxed to the extent that they exceed $737,000 in 2020.[62] Expatriation becomes effective only after all notification and tax satisfaction certificates have been properly filed with the IRS and the Departments of State or Homeland Security.

Form 8854 Initial and Annual Expatriation Information Statement must be filed with a US consular office or federal court at the time of expatriation and may also be required to be filed annually thereafter. Failure to file may carry a penalty equal to the greater of 5% of the expatriation tax or $10,000. Expatriates subject to the expatriation tax must also file **Form 1040NR** for each of the next 10 years after expatriation reporting US-sourced income only.

NOTE: Only US citizens and resident aliens are eligible for the Foreign Income Exclusion—since the expatriate has given up his citizenship, he is no longer entitled to this exclusion.

State Issues

Changing residency for state purposes may be equally challenging. California, for example, requires that a taxpayer must abandon his California domicile as well as physically move out of state with an intent to remain permanently or indefinitely in the new location (although intent alone is not always sufficient).[63] As a result, a taxpayer who moves abroad may still have a state filing requirement, even if he satisfies the BFR for the Foreign Earned Income Exclusion. Each taxpayer's situation will be evaluated based on facts and circumstances, including sale of the California residence; change of job; the establishment of business and social ties in the new state; even discontinuation of similar ties in California.

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[59] The income limitation is adjusted annually for inflation. In prior years, average annual net income had to exceed $151,000 (2012), $155,000 (2013), $157,000 (2014), $160,000 (2015), $161,000 (2016), $162,000 (2017), $165,000 (2018) and $168,000 (2019).

[60] To qualify for the exemption, such dual citizens must not have been US residents, held a US passport and never been present in the US for more than 30 days during any 10 calendar years prior to expatriation.

[61] IRC §877.

[62] The applicable exemption is indexed for inflation each year: $651,000 (2012), $668,000 (2013), $680,000 (2014), $690,000 (2015), $693,000 (2016), $699,000 (2017), $713,000 (2018) and $725,000 (2019). [Information for earlier years is available at https://thismatter.com/money/tax/expatriation-tax.htm, last accessed May 3, 2020.]

[63] *Homer E. Noble v. Franchise Tax Board*, 118 Cal. App. 4th 560 (2004).

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F. Foreign Cash Reporting

Each individual who receives or distributes any non-US currency or other monetary instrument, whether shipped, mailed or physically transported, in excess of $10,000 at one time must file **Customs Form 4790 Report of International Transportation of Currency or Monetary Instruments**. Monetary instruments include foreign coins and currency, money orders, traveler's checks, securities and negotiable instruments in bearer form. Funds transferred through normal banking procedures are exempt. This form is due within 15 days after taking receipt of the transfer[64] and must be filed with the Commissioner of Customs – Currency Transportation Reports Washington, D.C. 20229.

Other Forms

FinCEN Form 104 Currency Transaction Report must be filed by a US financial institution that receives the foreign funds in a single or series of transactions over $10,000.[65] Any person who physically brings, sends or receives $10,000 or more into the US must file **FinCEN Form 105** with the Commissioner of Customs or the Customs Officer when entering the US.

G. Sanctioned Countries[66]

In general, a US person – defined as any US citizen or resident, any US-based entity, or any person in the US (even if only temporarily) – is prohibited from engaging in most business activities with a sanctioned country. Such activities may include investing, depositing funds, and maintaining accounts in a sanctioned country, as well as selling or purchasing goods (in)directly to and from such country. Taxpayers who have engaged in prohibited business practices may run afoul of both the US income tax regime as well as FATCA rules; failing to report investment or business income and failing to declare reportable accounts. Practitioners should promptly warn such recalcitrant clients to immediately seek legal counsel.

VII. Reporting Foreign Accounts and Assets

A. Foreign Bank Account Report (FBAR)

A US person must *electronically* file **FinCEN 114 Foreign Bank Account Report** if, at any time during the calendar year, he had a financial interest in or signatory authority over one or more foreign financial accounts with an aggregate value of $10,000 or more.[67]

The annual reporting cycle is on a calendar year basis (January to December). Beginning with the 2016 tax year, the annual due date for reporting foreign financial accounts was

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[64] Civil and criminal penalties for not filing **Form 4790** may apply and the transferred funds may be subject to forfeiture or seizure.

[65] BSA e-filing of the FinCEN has been available since September 19, 2012 in lieu of paper filing of **Form 8300 Report of Cash Payments Over $10,000 Received in a Trade or Business**, although electronic filing is not (yet) mandatory.

[66] Updated list available at https://www.treasury.gov/resource-center/sanctions/programs/pages/programs.aspx (last accessed May 3, 2020).

[67] Mandated by the Bank Secrecy Act of 1970 (codified as Title 31 of US Code).

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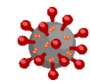
changed[68] to coincide with the federal income tax filing deadline on April 15th, with an *automatic* extension to October 15th available.[69]



While many filing deadlines were extended due to the COVID-19 pandemic, the FBAR deadline was not included. Indeed, because taxpayers receive an automatic six-month extension regardless, relief legislation that would have postponed filings from April 15th until July 15th, 2020 was superfluous. The filing deadline for FBARs due in the current year is October 15th, 2020.

The maximum penalty for failure to file is $10,000. If, however, violations are deemed to have been willful, penalties may rise to the greater of $100,000 or 50% of the unreported account value (plus possible criminal sanctions and jail time).

REMINDER: Taxpayers must also report interest and dividend income received from foreign sources on **Form 1040, Schedule B** and must check the box in Part III, Line 7 as "Yes" if the aggregate value of all foreign accounts was equal to or greater than $10,000 at any time during the year.

B. Foreign Assets

In addition to foreign account reporting, some taxpayers may be required to file **Form 8938 Statement of Specified Foreign Financial Assets**, which must be submitted to the IRS along with the taxpayer's income tax return.[70] If the taxpayer is not required to file an income tax return, he does not have to file **Form 8938**.

The **Form 8938** filing requirement was enacted in 2010[71] to improve tax compliance by US taxpayers with offshore financial accounts.[72] US citizens, residents, non-residents who elect to file a joint return with a US citizen or resident, and certain non-residents who live in a US territory must file if the total value of specified foreign assets exceeds specified thresholds.

Specified foreign financial assets include depository and custodial accounts at foreign financial institutions, stocks or securities issued by foreign persons, foreign pension or deferred compensation plans,[73] other financial instruments or contracts held for investment that are issued by or have a counterparty that is not a US person, any interest in a foreign entity[74] and gold certificates.[75]

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[68] Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Public Law 114-41.

[69] Previously, the filing deadline was June 30th, with no possible extension.

[70] IRC §6038D.

[71] Hiring Incentives to Restore Employment Act of 2010 (HIRE).

[72] The Foreign Account Tax Compliance Act (FATCA), enacted as part of HIRE, is intended to apply to "specified entities" as well as individuals. Effective for tax years beginning in 2016, domestic entities and trusts must also comply with **Form 8938** filing requirements [Treas. Reg. Sec. 1.6038D-6].

[73] Canadian Registered Retirement Savings Plans, for example, are reportable.

[74] IRC §6038D(b).

[75] IRC §1471(d).

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Filing Thresholds

The filing thresholds are higher for taxpayers who live abroad (referred to as "foreign" taxpayers) than for those who live in the US ("domestic" taxpayers). **NOTE:** Foreign taxpayers must satisfy the Bona Fide Residence or Physical Presence tests as per IRC §911. A taxpayer residing in the US must file if he has an interest in one or more specified foreign financial assets with an aggregate value of either $50,000 (single) or $100,000 (married) on December 31st. or $75,000 (single) or $150,000 (married) at any time during the year.[76] If residing abroad, **Form 8938** must be filed if the taxpayer has an interest in one or more specified foreign financial assets with an aggregate value of either $200,000 (single) or $400,000 (married) on December 31st, or $300,000 (single) or $600,000 (married) at any time during the year.[77]

The valuation of assets is based on the highest fair market value during the year, converted into US dollars at the applicable exchange rate on December 31st.

Foreign financial assets that have been reported on other forms – including **Forms 3520, 5471, 8621, 8865, 8891** – do not also have to be reported on **Form 8938**.[78]

The maximum penalty for failure to disclose specified assets is $10,000, plus $10,000 additional penalty for each 30-day period after IRS issues its 90-day failure to disclose notification. The statute of limitations for a tax return remains open until three years after an associated **Form 8938** with all reportable assets has been filed – if even just one asset is omitted, the entire return remains at risk! If failure to file is due to reasonable cause, the open statute will apply only to the item(s) related to the failure.[79] If a taxpayer fails to report gross income in excess of $5,000 attributable to reportable assets, the statute of limitations is extended to six years after the return was filed, whether or not the assets were reported on **Form 8938**.[80]

C. Form 3520 Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts

US persons who receive $100,000 or more in gifts and bequests from foreigners in a year must report those amounts on **Form 3520** by April 15th of the following year.[81] Additionally, US persons who receive distributions from foreign trusts must also use this form. Gifts and bequests are not taxable, but distributions from trusts are generally taxed as income. Taxpayers who receive a large inheritance in excess of $100,000 must file this form with their income tax return.

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[76] Reg. §1.6038D-2T(a)(1), Reg. §1.6038D-2T(a)(2).

[77] The regulations have not clarified filing threshold requirements for joint returns if one spouse resides abroad and the other lives in the US.

[78] **Form 5471** Information Return of US Persons With Respect, **Form 8621** Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, **Form 8865** Return of US Persons With Respect to Certain Foreign Partnerships, **Form 8891** US Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans.

[79] IRC §6501(c)(8).

[80] Additionally, a penalty equal to 40% of the resulting under-payment of tax will be assessed [IRC §6662(b)(7)].

[81] As per Rev. Proc. 2020-17, beneficial owners of foreign trusts that are operated (near) exclusively to provide retirement, medical or education benefits are exempt from the filing requirement.

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